The Taxpayer Relief Act of 1997 Provides Significant Tax Relief to Rural America

The Taxpayer Relief Act of 1997, perhaps the most important tax legislation in the last decade, is expected to significantly reduce Federal taxes for farmers and other rural taxpayers. While much of the tax relief is provided to middle-income families through a new child tax credit and education incentives, lower income rural taxpayers will also benefit from expanded Empowerment Zones and increased incentives to hire economically disadvantaged individuals.

In August 1997, President Clinton signed into law the Taxpayer Relief Act of 1997, the tax portion of the agreement to balance the Federal budget. This legislation, perhaps the most significant tax legislation in over a decade, will provide a total net tax reduction of about $95 billion over the next 5 years. The act contained a number of general and targeted tax relief provisions that will significantly reduce Federal taxes for rural taxpayers. It provides tax relief for families through a new child tax credit and several new tax incentives for education. Savings and investment are encouraged through expanded opportunities to contribute to individual retirement accounts and reduced capital gains taxation. The act also provides substantial estate and gift tax relief, especially to farmers and other small rural business owners. Finally, the act contains provisions that promote rural development through new rural Empowerment Zones and incentives to hire certain economically disadvantaged individuals.

Tax Relief for Families

Child Tax Credit. The act increases tax benefits for dependent children by providing a $500 ($400 for 1998) tax credit for each qualifying child under the age of 17. The child credit is phased out at a rate of $50 for each $1,000 of modified adjusted gross income in excess of $110,000 for married taxpayers filing a joint return and $75,000 for taxpayers filing as single or head of household. The amount of the credit is generally limited to the taxpayer's regular income tax liability. However, a portion of the credit is refundable for taxpayers with three or more children. For these taxpayers, the child credit is refundable to the extent that their regular income tax liability, the employee share of Federal Insurance Contribution Act (FICA) taxes and half of their self-employment tax liability exceeds the earned income tax credit. The new child tax credit is expected to benefit nearly one-third of all rural taxpayers and their families. The average credit amount for those eligible for the credit is estimated to be about $800.

Education Tax Incentives. The act creates two new nonrefundable tax credits for qualified tuition and fees for post-secondary education. A Hope Scholarship Credit of up to $1,500 (all of the first $1,000 and 50 percent of the next $1,000) is allowed for each student's tuition and related expenses during the first 2 years of college. A 20-percent Lifetime Learning Credit of up to $1,000 annually ($2,000 by 2003) is available for a taxpayer's tuition and related expenses for an unlimited number of years. The act allows nondeductible contributions of up to $500 per child to an education savings account for children under the age of 18. Distributions from such an account for qualified higher education expenses are tax free. The act also allows up to $2,500 of student loan interest to be deducted for each of the first 5 years that repayment of the student loan is required. All education incentives are phased out for taxpayers whose income exceeds a specified threshold amount, which varies depending upon the particular incentive. Finally, the exclusion for employer-provided undergraduate education assistance is extended through June 1, 2000. Rural residents, especially those families with children at or near college age, will benefit from one or more of these new education tax incentives.

Savings and Investment Incentives

Individual Retirement Accounts. The act expands the availability of existing IRA's and provides a new nondeductible alternative. With regard to existing IRA's, the income that an individual who is an active participant in an employer-sponsored pension plan can earn and still make deductible IRA contributions was increased. On a joint return, the adjusted gross income limit at which deductible contributions begin to be phased out rises by $10,000 in 1998 to $50,000, and to $80,000 by 2007. For single taxpayers, the

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amount increases by $5,000 in 1998 to $30,000, and to $50,000 by 2005. The act also allows spouses of individuals who are active participants to make their own deductible contributions, but the deduction is phased out if adjusted gross income exceeds $150,000. The new, nondeductible "Roth IRA's" allow tax-free distributions if funds are withdrawn after 5 years and the individual has reached age 59½, died, or become disabled. Contributions are phased out for couples with adjusted gross income over $150,000 and individuals over $95,000. Annual contributions to all IRA's remain limited to a total of $2,000. The act also allows penalty-free distributions from any IRA for higher education expenses and up to $10,000 of first-time home buyer expenses.

Only individuals who are covered by employer-sponsored pension plans, and their spouses, benefit from the expanded deductibility of IRA's. Nearly all rural households will qualify for the new Roth IRA's. Nonetheless, the share of farmers and other rural taxpayers who annually contribute to an IRA is relatively small (about 9 percent of farmers in any year and about 5 percent of other rural taxpayers). Thus, unless the new retirement saving options lead to a change in saving behavior, the increased availability may not result in a significant increase in retirement savings for rural taxpayers.

Capital Gains. The act reduced the maximum tax rate on capital gains held for at least 18 months from 28 percent to 20 percent. A 10-percent capital gains tax rate applies to taxpayers in the 15-percent marginal tax bracket. Because business assets are eligible for capital gains treatment, capital gains are an important component of income for farmers. About one-third of all farmers report some capital gain income each year. This is three times the frequency for all other taxpayers and twice that for other small businesses.

The act also allows a taxpayer to exclude up to $250,000 ($500,000 if married filing a joint return) of gain on the sale of a principal residence. This new exclusion can be used as frequently as every 2 years, and replaces both the previous provision that allowed the gain to be rolled over into another residence and the $125,000 lifetime exclusion for taxpayers over 55 years of age. Most rural residents will be exempt from tax on the sale of their residence as a result of this new provision. This includes farm residences, which represent about 12 percent of the value of farms.

Tax Relief for Farmers and Other Rural Businesses

Self-Employed Health Insurance Deduction. The self-employed health insurance deduction is intended to give small business owners tax benefits similar to employees receiving employer deductible health insurance. In 1997, self-employed individuals were allowed to deduct 40 percent of the cost of providing health insurance for themselves and their families. This amount was scheduled to increase to 80 percent by 2006. The 1997 Act accelerates the scheduled increases and will allow 100 percent of the cost to be deducted by 2007. This will reduce the after-tax cost of purchasing health insurance for those farmers and other rural business owners who must purchase insurance on their own.

Alternative Minimum Tax. The act repeals the alternative minimum tax (AMT) for small corporations for tax years beginning after 1997. A small corporation is defined as a corporation with 3-year average annual gross receipts of $5 million or less for the first tax year beginning after 1996 and with annual gross receipts of $7.5 million or less for any later years. This change will allow most farm and other rural small business corporations to avoid the complexities of the alternative minimum tax.

The act also provides a lower tax rate for individual taxpayers on net capital gain for alternative minimum tax purposes. Under the change, net capital gain is taxed at the same rates that apply for regular income tax purposes. Thus, capital gain that is taxed at 20 percent for regular income tax purposes will be taxed at 20 percent for AMT purposes rather than the alternative minimum tax rate of 26 percent.

Estate and Gift Tax Relief. Only about 1 percent of all estates are subject to the estate tax. Thus, estate and gift taxes are not a major concern for most rural taxpayers. However, while the aggregate importance of estate and gift taxes may be small, the potential impact of such taxes on an individual or group of individuals, such as farmers and other small business owners, can be substantial.

Concern for the effects of Federal estate taxes on farmers and other small business owners who hold significant amounts of wealth in business assets was the primary impetus for the changes to Federal estate and gift tax laws in the 1997 Act. The act substantially increases the size of a farm or other business that can be transferred tax free by increasing the basic amount each individual can transfer tax free (the unified credit) from $600,000 to $1 million by 2006 and by providing a new exclusion for qualified family business interests of up to $675,000 in 1998. The act also makes important changes to the installment payment provision which allows taxes to be paid over a 14-year period rather than within 9 months of death. These changes include lowering the interest rate from 4 to 2 percent and increasing the size of an estate eligible for this low interest rate.

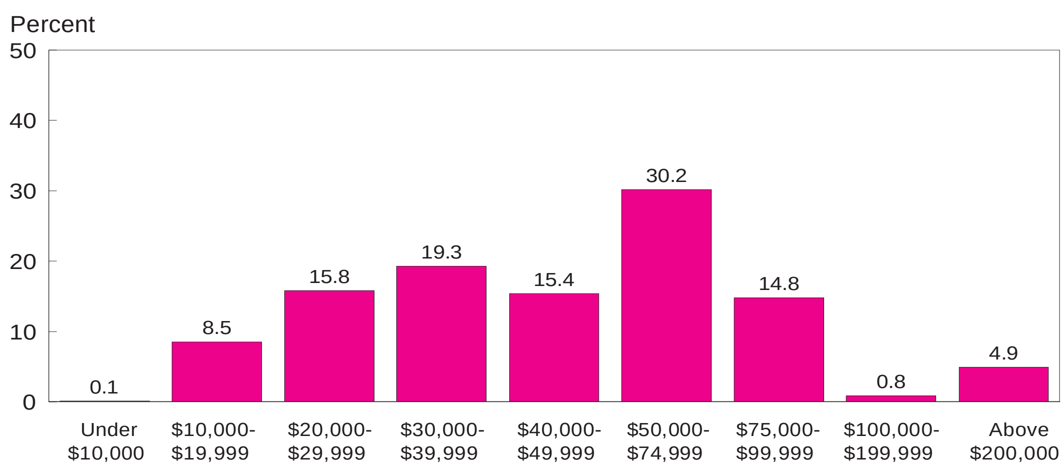
The overall effect of the 1997 changes to Federal estate and gift tax policies is that fewer farmers and other small business owners will be required to file a return or pay taxes. Those required to pay will owe less tax and will be eligible for more favorable payment terms. Thus, these changes will make it easier to transfer the family business across generations by reducing the likelihood that the business or some of its assets will need to be sold to pay estate taxes.

Special Tax Benefits for Farmers. Farmers were major beneficiaries of the 1997 Act. In addition to the general provisions, which accounted for most of the tax reduction, the act contained a number of provisions targeted specifically to farmers. These included allowing farmers to use the installment sales method of accounting for alternative minimum tax purposes, allowing farmers to defer the gain on the sale of livestock due to floods and other weather-related conditions, and temporarily restoring the ability of farmers to lower their tax liability by shifting farm income to the 3 prior tax years. The combined effect of these as well as the other changes contained in the 1997 Act, especially the capital gains and estate and gift tax provisions, is estimated to reduce Federal tax burdens for farmers by about $1.8 billion per year.

Special Tax Incentives for Low-Income People and Places

Since most of the new tax credits are not refundable and the benefits are phased out for higher income taxpayers, the primary beneficiaries of the 1997 Act are middle-income taxpayers (fig. 1). Higher income and wealthier taxpayers primarily benefit from capital

Figure 1
Distribution of tax benefits under 1997 Act for 1998
Benefits targeted to middle-income classes



Source: U.S. Congress Joint Committee on Taxation.

gains and estate and gift tax provisions. However, the 1997 Act also provides some new and expanded tax benefits targeted to low-income people and places, including incentives to hire employees from targeted groups of disadvantaged individuals or places or to encourage private enterprise development in high-poverty or distressed areas.

New Empowerment Zones. The 1997 Act authorizes the Secretaries of HUD and Agriculture to designate an additional 20 Empowerment Zones with no more than 5 of these zones to be located in rural areas. Thus, the number of rural Empowerment Zones will increase from three to eight. However, the tax incentives for the new zones are different from those available for the earlier zones (see General Assistance article).

Work Opportunity Tax Credit. The work opportunity tax credit encourages employers to hire employees from one or more of seven target groups. The seven target groups include (1) members of a family receiving assistance under the Temporary Assistance to Needy Families (TANF) program, (2) a veteran who is a member of a family either receiving AFDC assistance or assistance under a Food Stamp program, (3) an individual convicted of a felony who is hired within 1 year after conviction or release from prison and who is a member of a family whose income is 70 percent or less than the Bureau of Labor Statistics lower living standard, (4) an individual between the ages of 18 and 25 who lives within an Empowerment Zone or Enterprise Community, (5) an individual who is 16 or 17 years old who performs services for the employer between May 1 and September 15 and lives in an Empowerment Zone or Enterprise Community, (6) an individual who has a physical or mental disability that is a substantial handicap to employment, and (7) an individual between the ages of 18 and 25 who is a member of a family receiving assistance under a Food Stamp program. The credit was scheduled to expire on September 30th, 1997, but was extended by the 1997 Act for 9 months through July 1, 1998. The act also expanded the number of target groups to eight by adding a group for qualified supplemental security income recipients. The rate of the credit was also changed from 35 percent to 25 percent of wages for employment of more than 120 hours but less than 400 hours and 40 percent of wages for employment over 400 hours or more. Since the credit is higher for wages paid for employment over 400 hours, the maximum credit varies depending upon the proportion of wages eligible for the 40-percent rate. The deduction for wages paid is reduced by the amount of the credit.

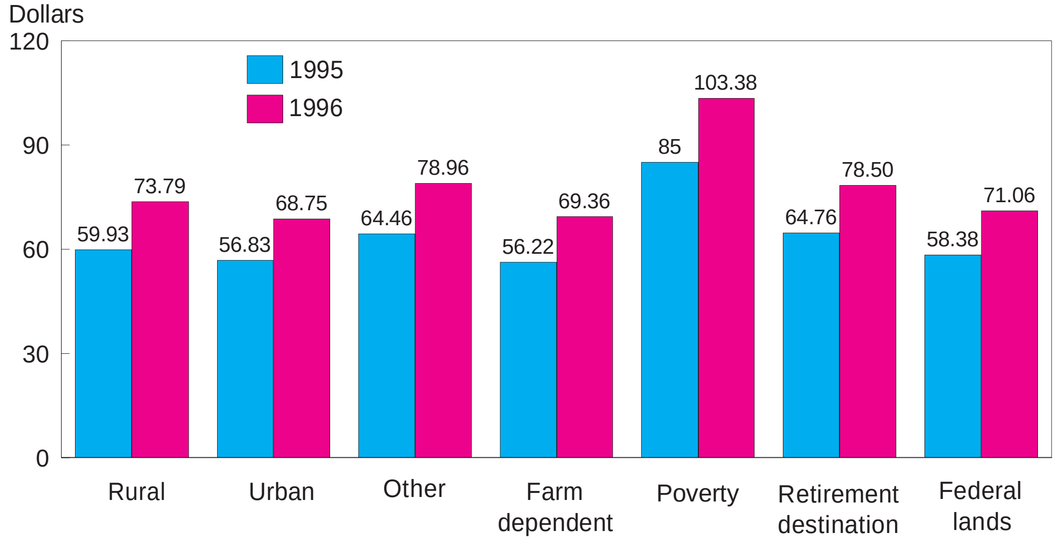
Welfare-to-Work Tax Credit. The act contains a new credit to provide employers an incentive to hire long-term public assistance recipients. The credit is equal to 35 percent of qualified first-year wages and 50 percent of qualified second-year wages. For purposes of the credit, wages are broadly defined to include not only actual wages but educational assistance covered by the tax exclusion for employer-provided tuition assistance, health plan coverage, and dependent care assistance. The credit applies to up to $10,000 per year, resulting in a maximum credit of $8,500 for the 2 years. An eligible employee must be certified as a long-term family assistance recipient by a State employment security agency. The new credit applies to employees who begin work after December 31, 1997, and before May 1, 1999. For most profitable businesses, the credit will reduce the after-tax cost of hiring a targeted employee earning $10,000 per year to about $8,000 for the 2 years. This credit is expected to assist States and localities in adjusting to the welfare reform legislation enacted in 1996 (see Welfare Reform Followup article).

Earned Income Tax Credit Developments. The 1997 Act continues recent efforts to more precisely target the earned income tax credit (EITC), a refundable tax credit available to low-income workers who satisfy certain income and other eligibility criteria. The EITC is phased out if earned income or modified adjusted gross income exceeds a specified threshold amount. The 1997 Act adds two new nontaxable items in determining income used for phasing out the benefits of the earned income tax credit. These items are tax-exempt interest and the nontaxable portion of any pension, annuity, or distribution from an individual retirement account. The new law also increases the amount of losses from a business, including farming, that are disregarded from 50 percent to 75 percent. This change will affect a relatively small number of tax credit recipients but will dispropor-

Figure 2

Per capita earned income tax credit benefits by type of State, fiscal year 1995-96[1]

1996 benefits increased significantly compared with those in 1995[2]



[1] Refundable portion of credit only.
[2] See data definitions for State classifications.
Source: Calculated by ERS using Federal Funds data from the Bureau of the Census.

tionately reduce benefits to farmers since over half of all farmers report a net loss for tax purposes each year.

The earned income tax credit has increased in importance for low-income rural workers with the phase-in of the 1993 expansion of the credit. For fiscal year 1997, the first year to fully reflect the full phase-in of the 1993 changes, the credit provided low-income workers and their families about $28 billion in benefits with the rural share estimated at about $7 billion. About one out of every five rural residents benefited from the credit. The credit continues to provide the greatest benefits to those States classified as persistent poverty States, with the refundable portion of the credit alone providing an average per capita benefit of $103.38 in fiscal year 1996 (fig. 2). Furthermore, despite the new targeting provisions contained in the 1997 Act, the total value of the credit is expected to continue to increase, although at a much slower rate, with the total credit estimated to reach $28.5 billion in fiscal year 1998.

Fewer Tax Policy Changes Expected in 1998

The potential for a budget surplus in fiscal year 1999 enhances the prospects for further tax reductions in 1998. The Administration has proposed tax relief to provide child care assistance for working families as well as new tax incentives to promote energy efficiency, retirement savings, and increased education expenditures. Congressional proposals include relief from the alternative minimum tax, further reductions in Federal estate and gift taxes, and a reduction in the marriage penalty. Given the increasing priority being placed on addressing the long-term solvency problem of social security, however, the amount of tax relief enacted in 1998 should be limited, especially in contrast to the 1997 legislation. *[Ron L. Durst, 202-694-5347, rdurst@econ.ag.gov]*